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Government and Public Finance

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Source: *The Economic Journal*, Vol. 17, No. 68 (Dec., 1907), pp. 513-523

Published by: Wiley on behalf of the Royal Economic Society

Stable URL: <http://www.jstor.org/stable/2220852>

Accessed: 27-06-2016 04:41 UTC

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The Economic Journal

GOVERNMENT AND PUBLIC FINANCE

THERE are from a financial point of view a variety of reasons why the transaction of certain affairs should become public functions. One of these reasons, and perhaps the most important, is the short-sightedness of the average consumer. The object of private undertakings is to earn a profit, or, in other words, to obtain for the trouble expended and the capital invested a return commensurate with the usual cost of such labour, and the customary profit on such capital. The bulk of our economic activities, in agriculture, industry, and commerce, is of this order, and it is generally taken for granted that the big profits of the most successful undertakings are the due reward of the superior quality of the services rendered. This presupposes that the consumers are the best judges of the value of the services for which they pay—an assumption no doubt sufficiently justified in the case of bread and meat, boots and clothing, and many other articles of daily need. But there are commodities which differ essentially from the common ruck, goods of a higher order, not adapted to the satisfaction of any material need, and therefore neither so universally and keenly desired, nor so judiciously appreciated. Nevertheless, some of these goods are so indispensable to the well-being of a civilised nation to-day that a wise legislature brings persuasion in the form of law to bear upon all citizens whose tastes may not lie in these directions. The leading example which we have in view is the case of elementary education. If the satisfaction of this want were left to the free play of economic activities, we may be sure that the supply offered would be inferior in quality and insufficient in quantity. The demand, on the other hand, would be slight and probably unintelligent. Public schools and compulsory attendance are the remedy for this evil. As however the want of popular demand for elementary education is due as much to poverty as to lukewarmness in the desire for instruction, the Government tries to temper the harshness of the obligation which it imposes by making the people a free gift of this unappreciated commodity. The cost of public education then is borne, not by the parents of the children, but by the

taxpayer, and there arises a new item of expenditure which the public purse must find a means of covering. It is a well-known fact that the development of elementary education in Germany, more especially during the last decades, with its growing requirements in the matter of salaries, buildings, educational appliances, baths, and so forth, constitutes an increasing stream of expenditure which has not by any means reached its maximum.

A parallel, if not exactly similar, case is to be found in the higher education of that smaller section of the population which is composed of the well-to-do or the specially gifted of all countries. This need is met by the financial sacrifices which have given us the endowed foundations of the old and new Universities of England, Scotland, and Ireland, and the higher educational centres of the oldest States of the American Union. Or else the burden is still borne by the taxpayer, whose contributions maintain the Universities of Germany, Switzerland, Austria, France, Italy, and Russia with occasional relief in the form of gifts and endowments, as in the German Universities and a few of the modern German Commercial Schools.

Without some sacrifice on the part of the State or the municipality, or without private munificence, nothing of importance is achieved in the realm of education. The principle of economic exchange (*do ut des*) is insufficient to meet the need, and never more so than to-day. And higher education is no exception to this rule. The only conspicuous example of an educational institution achieving some degree of success on these lines is afforded by the Swiss boarding school for young ladies and a few High Schools in Belgium and France.

There is a sufficiently easy method of escaping the financial burden indicated above. The State or the town may repudiate them as lying altogether outside its province. Hospitals, for example, which in German towns absorb a considerable portion of the public revenue, are in England exclusively dependent for their support on voluntary contributions. The only question is, which method is best adapted to obtain the end desired? The more convenient method of relying on voluntary support was once considered suitable for elementary education also, and it was not until the importance of universal instruction came to be realised that a safer and sounder method was adopted.

II.

There are other duties belonging to the State or the municipality which do not impose so heavy a burden on the public

funds as the provision of education. We refer to such undertakings as gasworks, waterworks, tramways, electrical supply works, and so forth. The older tradition of all countries had been to leave these matters to private enterprise; lately, however, they have passed under the control of local bodies, not only in Germany and Switzerland, but also in England. To supply, free of charge, these services, which are by no means intended for the poorer classes of the population only, but are at least as useful, if not more so, to the well-to-do, would be wrong and unjust. Each class enjoys them according to its needs; it is therefore just that all should pay for this sort of service in proportion to the extent to which they avail themselves of it, and that they should pay a price adequate to cover the cost of the service rendered. These undertakings therefore should not be run either at a loss or with a view to profit; they are withdrawn from the sphere of private enterprise in the first place, because it is believed that they can be worked better and more economically under public administration, and, in the second place, because they are in a measure monopolies, and it is supposed that in such cases the interests of the community are most efficiently protected under a system of public control.

From the financial point of view these institutions serve their purpose most successfully when they show neither a surplus nor a deficit in their yearly budget, *i.e.*, when they belong neither to the revenue nor to the expenditure side of the national account. This state of equilibrium is, however, occasionally influenced by considerations not altogether unlike those which led to the provision of free elementary education. Public baths, for example, have long since been provided in some German towns, especially in connection with the elementary schools, at a charge which does not cover the cost incurred. It was hoped in this way to bring their use within the reach of the lowest ranks of the population. The water companies, for similar sanitary reasons, fix the price of the water which they supply below the cost of production. So too, tramways either reduce their tariff to a rate which spells loss, out of consideration for the poorer class of travellers, or they offer their employees such favourable conditions in the matter of wages or hours of work, that the receipts cannot cover the expenditure. It would, of course, be desirable in all these cases that the receipts should exactly balance expenditure, so that the end should be attained without the financial sacrifice above-mentioned—desirable, that is, from the financial point of view, for every deficit of this nature must be made good by receipts from other sources.

The chief and most important example of an institution as above described is furnished by the State railways of Germany, Switzerland, and other countries. These are for the most part organised on a basis of financial equilibrium, for the vast amount of capital invested in these undertakings requires an adequate rate of interest, and any deficit in the revenue earned must be made up from other quarters. The popular view that losses of this kind are amply justified by the indirect advantages derived from cheap transport is not only unwarranted, but if urged as a general principle, becomes fraught with grave financial dangers. On the other hand, the Government which sets out with the intention of running its railways at a profit, is now almost a thing of the past. It is generally considered so important to provide the opportunities for passenger and goods traffic at cheap rates, that equilibrium is the principle adopted—the earnings of such an undertaking, it is generally agreed, shall not do more than cover the necessary expenditure. The practice of the world has been more or less in accordance with this theory. There is, however, one conspicuous modern exception—the Prussian State railways—the consideration of which is the principal aim of these pages.

III.

National institutions, the sole object of which is to earn a revenue, are no novelty. As an example we may quote the ancient French monopolies. The Government monopoly of salt existed in the Roman Empire, in the towns of mediæval Europe, in France until the Revolution, in Germany until thirty years ago, and exists in Switzerland to this day. It is only occasionally, as for example in the Canton of Zürich, that a monopoly endures without serving a financial purpose. In France the tobacco monopoly was instituted by Colbert, abolished during the Revolution, and restored by a decree of Napoleon, since when it has remained one of the most important items in the French fiscal system. This monopoly is also a valuable asset in the budgets of other countries, such as Austria, Italy, Spain, &c.

The monopoly of the Postal Service dates from the same epoch, when the growing power of the monarchy in England, France, Austria, and Germany asserted itself by introducing new monopolies with a view to financial gain. It differs, however, in one respect from the purely financial monopolies, such as, *e.g.*, those of tobacco and salt. For these are simply a form of taxation, while the Postal Service has always to some extent served

a further purpose. The Government itself required a medium for the transmission of its own communications (in the Roman Empire this was the sole object of the "Cursus Publicus"). The public also needs a service and must be provided with some reliable institution, to which its letters, parcels and passengers can be entrusted. The old fiscal character of the Post Office and similar institutions is being more and more abandoned by a certain school of economists backed by the prejudice of public opinion, while its other functions are brought into proportionally greater prominence. It has become a favourite dogma that a profit on the administration of the Postal Service is inconsistent with the object of the undertaking, and that the State is no more entitled to benefit from a surplus which may arise on the yearly income of this department, than a co-operative store, which has to divide its available surplus among its members at the end of the year.

There is no heresy in the face of this dogma so impressive as the five millions sterling which the British Chancellor of the Exchequer annually receives from the General Post Office. The Radical reformers who succeeded in substituting penny postage for the high rates that used to be in force, are justified by the course of events. They maintained that the enormous increase in the volume of correspondence, which would follow on the introduction of penny postage, would prevent any material decrease in the profits of the department. It is true that Sir Rowland Hill somewhat overrated the immediate financial success of the facilities which he introduced. But his prophecies are all the more justified by the success which has been attained to-day.

And why does the English Government—in the face of popularly accepted dogma—cling to this inconsistency? Simply because a branch of the national administration, whether originally instituted with a view to financial gain or not, can become a suitable source of revenue, provided it succeeds in attaining this object with as much ease and justice and as little oppression as any of the ordinary methods of taxation. And the final test is the amount of revenue which can thus be earned, as compared with the yield of the alternative method of taxation. There is indeed no other source of revenue which yields a sum as large as that earned by the English Post Office under such moderate conditions. In no other case is the pressure so slight or the manner of the distribution of the burden so unexceptionable. And if we were seriously to consider the suppression of this profit and the substitution of some other form of taxation in order to

conciliate popular prejudice, we should be much puzzled to find a suitable alternative. We should surely not propose an increase in the income-tax, or in the duties on tea, beer, brandy, &c. But then—what?

It is a favourite custom to criticise all the existing sources of national revenue adversely by emphasising the special drawbacks attaching to each, but no statesman, and no one who feels in any way responsible for the conduct of public affairs, can afford to indulge in this facile criticism without at the same time pointing to some alternatives which are free from the disadvantages in question. This is the only fruitful sort of discussion, and the only form which deserves to be called scientific. It is therefore from this point of view that we must discuss the latest development of the Prussian Budget and the influence of the State-railway finance.

It is well known that soon after the foundation of the German Empire a scheme was mooted to transform all the railways of Germany into a single Imperial system. The tradition of the several German States had long been in favour of centralised systems of communication—each State already had its high-roads, canals, and railways under Government control. Moreover, the scheme represented the absolute ideal of a railway system, since in this, as in all other systems of transport, whatever makes for unity makes for success. The scheme was wrecked by the unwillingness of the smaller German States to accede to so thorough-going a form of centralisation, although, or perhaps precisely because, such centralisation would have been the logical outcome of Imperial unity.

The immediate consequence was the consolidation of the individual railway systems, which was a marked advance, especially in the larger States. A number of the most important Prussian lines were owned, not by the State, but by joint-stock companies. The majority of them belonged to the first period of railway construction—a time when for financial reasons the Prussian Constitution did not admit of the building of State lines. These railways were acquired by the Prussian Government in 1880 by an arrangement which was absolutely voluntary on both sides, and at a price which not only agreed with the market price, but even left the shareholders a considerable margin of profit.

The opponents of the nationalisation of railways are prone to contend that nationalisation spells ruin for the finances and the credit of a State, because the purchase of the lines requires enormous sums of capital or a disastrous resort to credit. This con-

tention is as old as the project of William Galt in 1843, and comes to the front again, after the manner of such arguments, at every opportunity. It did so in the Prussian Parliament about thirty years ago. Indeed, the Prussian Government was not at all disposed to urge the financial advantages of the scheme under consideration. It was always the interests of traffic, the economies likely to result from the working of the railways on a single unified plan, and the beneficial influence which governmental administration would exert on the tariffs, that were emphasised, while it was incidentally taken for granted that the net result for the finances of the State would be a loss rather than a profit on the undertaking.

The actual result was startlingly different. Since the year 1882 the revenue earned by the Prussian State railways has not only sufficed to pay the interest on the capital and wipe out the debt, but over and above this, has yielded a surplus which has remained at the disposal of the Government for other national expenses. The figure of this annual surplus has steadily increased from £1,000,000 in the years 1882-1887 to £23,000,000 in 1905, and in the Budget of 1907 it is estimated at £30,000,000 (591,000,000 marks). This amounts to very little less than three times the yield of the Prussian income-tax, or more than double the income and property-taxes taken together (£13,000,000). Yet these two are still the cardinal points of the Prussian fiscal system, and so long as the railway surplus played no very important part, *i.e.*, until 1887, financiers were completely dependent on their productivity. The situation has been changed since 1890, when the railways began to contribute sums of from four to five millions to the national exchequer. Since then the figures have rapidly increased (in 1897 the surplus was ten millions), so that the grand total for the years 1882-1907 amounts to about £260,000,000.

This does not mean that the financial principles which now prevail are any different from those which the Government propounded thirty years ago in order to justify the nationalisation of the railways. The interests of traffic, which were so warmly and exclusively urged, as an argument in favour of the purchase of the railways, were not afterwards postponed to the interests of public finance. The Government remained loyal to its principles without *arrière pensée*, yet the above-mentioned favourable results were obtained.

It must, of course, be admitted that rigid adherence to the greatest-interest-of-the-traffic principle pointed to the return of the entire surplus earned by the railway to the consumer in the

shape of reduced fares. The point at issue, however, is not so much what shall be done with the surplus as why the surplus exists. To this question no certain answer has as yet been found; the solution is no easy matter and requires very minute researches into the facts to hand. In the meantime we can only resort to hypotheses, such as the advantages which a great railway system derives from a centralised administration, the superiority of Government control over the rule of the companies, or the enormous expansion of traffic in North Germany during the past twenty years. And we must keep in mind the fact that the Prussian railway administration has not by any means been one of narrow-minded parsimony. Considerable reductions have been made in the rates of travel, more especially in the goods traffic, and it is precisely and exclusively in this department that the surplus has been earned. A number of new lines have been constructed, which have diminished the net profit of the whole system; the rolling stock, &c., has been much improved, and new stations have been built, to the extraordinary magnificence of some of which no other country can produce a parallel.

To condemn the surplus—to regard it as a drawback to the nationalisation of the railways—springs from logical confusion. The surplus is certainly no disadvantage from the point of view of the national exchequer. It might be counted a disadvantage for the individual traveller, if we had any reason to believe that the companies would have supplied him with the same facilities at lower prices. No such reason exists. And in the absence of such proof, it is clearly more advantageous to the community that the profits deriving from the same scale of railway rates should find their way into the pockets of the taxpayers, rather than into the pockets of the shareholders. That the profits of the shareholders would have been forcibly reduced in favour of the public by any such agency as competition, public opinion, Act of Parliament, or what not, *i.e.*, that the shareholders would not have been allowed to enjoy the profit that now accrues to the State, is a supposition not in any way borne out by past experience. Whether the Pactolus of the railway profits may not, like winnings at games of chance, have encouraged the Prussian Parliament in reckless expenditure, is another question. But this, too, must be answered in the negative. The money has been expended on improved equipment for elementary education, on the Universities, museums, and public buildings; it has been utilised in the interests of science and art, or for raising the salaries of the numerous officials in the service of the State. It is true that this

expenditure would not have been incurred if the only means of meeting it had been an increase in taxation. The question at issue, then, reduces itself to this: Were these new objects of expenditure more important than a reduction of railway rates, or should the railway rates have been reduced first, the other expenses postponed until such time as the requisite funds could be raised by the imposition of fresh taxes? A definite proof of the point is naturally somewhat difficult. But in view of the increasing expansion of traffic on the Prussian lines, we are of the opinion that the course chosen was the correct one. There remains, however, one problem, of which we shall proceed to treat.

IV.

Everywhere, and more especially in Germany and England, national expenditure increases with irresistible might. The glamour of wealth, the progress of inventions, the awakening of new needs, the spread of these through the masses of the population, the entire progress of culture—all these agencies have combined to produce a host of new wants in which the economy of States and municipalities is very intimately concerned. The most important item of the expenditure side of the Budget, the upkeep of the Army and Navy, belongs to the Empire, and the individual German States are therefore relieved of this burden. It is all the more remarkable that the peaceful needs of the several States nevertheless continue to make increased demands on the resources of the exchequer. And there is no question regarding the nature of the objects for which these increasing financial sacrifices are exacted; far from earning the description of extravagance and folly, they are eminently serious and worthy of consideration. The only problem is what form the sacrifices shall take.

Prussia reformed her system of taxation in 1891–1893. The income-tax was made more productive by improved methods of assessment; the land-tax and house-tax were made over to the sphere of municipal taxation, while, on the other hand, a new property-tax was introduced by the State. It was categorically stated by the Government in power that this reform did not aim at raising the existing taxes, but only at making their distribution more equitable. Now the yield of the income-tax has more than doubled; nevertheless, the figures quoted above show that it has failed to keep pace with the national expenditure. The gap had to be filled by the railway surplus—and so the profits earned by the Government on one of its services were substituted for direct

taxation on a scale quite unprecedented in the history of finance. This substitution is undeniably a *pis-aller*, and the raising of the income and property-taxes would have been a sounder procedure. Still, when we reflect that to give up the railway profits and at the same time to keep up the figure of our national expenditure would involve a doubling or trebling of the income and property-taxes, we get some idea of the difficulties that beset the question. We have a close analogy in the case of the generous sums yielded by certain indirect imposts, the raising of which by direct taxation would be a matter of much difficulty.

This is so well recognised in Prussia that no one to-day would seriously suggest any alteration in the existing state of affairs. Nevertheless, we have now reached a point where the railway surplus will not admit of further levies, and any increase in expenditure can only be met by a rise in direct taxation. And this crisis is actually upon us, for Parliament has recently voted six and a half million sterling for the augmentation of the salaries of State officials, a sum equal to about one-half the yield of the income and property-taxes hitherto in force. To draw further on the railway profits would be inconsistent with sound public finance. Moreover, the occasion serves us as a timely reminder to choose a sounder mode of taxation than the one which has been in use for twenty years.

But what is sound? The circumstances which call for an increase in the national expenditure are characteristic and specially significant for the coming reform of taxation. It is proposed to increase the incomes of State officials in accordance with the raised standard of living which now prevails. Hundreds of thousands of families, whose heads earn from £100 to £500 a year in the service of the State, are to see their lot substantially improved. Is it fair to obtain the means for this improvement by the imposition of a new burden on the remaining citizens of the country whose incomes reach the same figure? And would it not be absolutely paradoxical to withdraw, by means of this new tax, a portion of their increased pay from the very persons whom we set out to benefit? There is only one way out of the dilemma, *i.e.*, to impose the new burden on incomes of over £500 only, by means of a progressive scale which taxes the larger incomes, those above £1,000, £2,000, and so forth, with increasing percentages.

The system which exists in Prussia at present takes its toll from all incomes of £45 and upwards. The minimum rate is $\frac{2}{3}$ per cent.; it rises to 3 per cent. on incomes of £450, and to a maximum of 4 per cent. on incomes of £5,000. A further pro-

perty-tax, amounting to $\frac{1}{2}$ per thousand on capitalised values, that is, a moderate additional tax on that part of income which is interest on capital and not remuneration of effort, was introduced in 1893. We should recommend a considerable rise in the two last-named taxes, first, on the grounds of bare justice and equity ; secondly, as a method of equalising the indirect burden represented by the railway profits ; and, lastly, as compensation for the undue weight with which all indirect Imperial taxation presses on the lower classes. This pressure, we may add, will be all the greater when the reforms, which our fiscal system calls for in the immediate future, have been consistently carried out.

The obstacle which lies across the path of any such reform in Prussian taxation is the predominant influence of the propertied classes in both Houses of Parliament. The only means of counter-acting this influence would be to reform the existing franchise, which would seem to have been constituted for the express purpose of protecting the interests of the propertied classes against the inroads of social justice.

It is no part of our purpose, however, to probe the future in this direction. We have examined the existing situation in order to show that it was the logical outcome of the peculiar development of the German administration. We have seen how the remarkable activities of the Government led to unexpected consequences in the realm of public finance. These point the way to future developments which may at any moment appear in other countries—even in those which are at present organised on very different lines. It was desired to show what unexpected results follow from an expansion in the sphere of government, because this expansion probably represents the typical development of all civilised States in the future.

GUSTAV COHN